

Internal Revenue Service

memorandum

CC:TL-N-7505-88

Br4:GBFleming

date: **SEP 02 1988**

to: District Counsel, Manhattan NA:MAN
Attention: Sharon Katz-Pearlman

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED] - Limitation on Amount of Percentage
Depletion under I.R.C. §§ 613(a) and 613(c)

This is an interim response to your memorandum dated June 27, 1988, requesting technical advice concerning issues raised in the nondocketed case, now pending before New York Appeals, involving the above-named taxpayer for taxable years [REDACTED] - [REDACTED].

ISSUES

1. Whether the amount of gross income used to calculate the percentage depletion deduction is limited to the gross income actually earned from the property pursuant to fixed-price contracts.

2. Whether the taxpayer may use the representative market or field price ("RMFP") to determine the depletion allowance when the RMFP exceeds the contract price.

CONCLUSIONS

1. The taxpayer's percentage depletion allowance should be computed based on a gross income amount that does not exceed the gross income actually earned from the property pursuant to fixed-price contracts.

2. In computing the depletion allowance where the [REDACTED] is transported away from the property prior to sale, the taxpayer may not use a RMFP that exceeds the contract price.

FACTS

For the taxable years at issue, the taxpayer transported [REDACTED] produced from certain properties through its own [REDACTED] and sold it on a delivered basis under long-term, fixed-price contracts. Because the [REDACTED] was transported

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away from the [REDACTED] prior to sale, the taxpayer calculated its percentage depletion deduction for the properties based on the RMFP instead of the contract price, the amount actually received for the [REDACTED]. Because the RMFP was greater than the contract price, the amount of the taxpayer's claimed percentage deduction was greater than if it had used the contract price.

Examination and Appeals have taken the position that the taxpayer's use of the RMFP was incorrect and that the base for calculating the percentage depletion deduction is limited to the actual income derived from the property. The taxpayer contends that its use of the higher RMFP is proper under Treas. Reg. § 1.143-3(a), which provides for using the RMFP where the [REDACTED] is transported from the property prior to sale.

DISCUSSION

In view of the significance of the issues raised by your request and the taxpayer's apparent intention to litigate this matter, we have forwarded your request to the Interpretative Division for their consideration and assistance. We also prepared a briefing memorandum for the Chief Counsel, a copy of which is attached for your information. Upon receiving the response of the Interpretative Division, we will prepare a memorandum setting forth a complete explanation of Service position. In the interim, we have outlined below our preliminary analysis in support of the conclusions stated above.

For years prior to 1975, I.R.C. § 613(b) provided for percentage depletion of [REDACTED] and [REDACTED] by all owners of economic interests. For years after 1974, I.R.C. § 613(d) provides that in the case of [REDACTED] and [REDACTED] the allowance for depletion shall be computed without reference to section 613, except as provided in section 613A.

I.R.C. § 143(a) provides that except as provided in this section the allowance for depletion under section 611 of the Code with respect to any [REDACTED] or [REDACTED] shall be computed without regard to section 613. Under section 143(b) the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to [REDACTED] sold under a [REDACTED].

Treas. Reg. § 1.143-3(a) provides that if [REDACTED] is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the [REDACTED] before transportation. In addition, Treas. Reg. § 1.143-3(c)(6)

provides that a price is not a RMFP for the taxpayer's ore or mineral if the sum of such price plus the total of all costs of the nonmining processes (including nonmining transportation) which the taxpayer applies to his ore or mineral regularly exceeds the taxpayer's actual sales price for the first marketable product or group of marketable products. Treas. Reg. § 1.613-5(a) provides that the term "taxable income from the property" means "gross income from the property" less all allowable deductions (excluding any deduction for depletion) which are attributable for mining processes.

As a general matter, the taxpayer is correct that, for purposes of percentage depletion, gross income in the case of [REDACTED] that is transported from the property before sale should be based on the RMFP, as provided in Treas. Reg. § 1.613-3(a). What the taxpayer ignores, however, is the provision in Treas. Reg. § 1.613-3(c)(6) which effectively limits the sum of the RMFP and all nonmining costs to no more than the actual sales price for the [REDACTED].

Although the taxpayer will probably argue that the limitation of § 1.613-3(c)(6) applies only to a RMFP for [REDACTED], we believe that it is equally applicable to a RMFP for [REDACTED] and [REDACTED]. We do not view the reference in that provision to "ore and mineral" as referring solely to [REDACTED]. On the contrary, we can point to other provisions of the depletion regulations that are framed using mining terms but are recognized as applying not only to [REDACTED] but also to [REDACTED] and [REDACTED]. For example, Treas. Reg. § 1.613-5(a) refers to "mining processes" but applies to [REDACTED] and [REDACTED] as well as [REDACTED].

For [REDACTED] and later years, we may wish to argue that the taxpayer does not qualify under the [REDACTED] exemption provided in section [REDACTED](b). If so, it may be advisable, for reasons of strategy, to concede the pre-[REDACTED] years. At the present time, however, the taxpayer's position should be vigorously opposed, and no attempt should be made to compromise our litigating position through any unnecessary concession of a substantial portion of the deficiency. The legal basis for our position will be thoroughly researched and a technical advice memorandum fully advising District Counsel of the arguments that should be presented by Appeals and any subsequent Examination document will be issued no later than December 31, 1988.

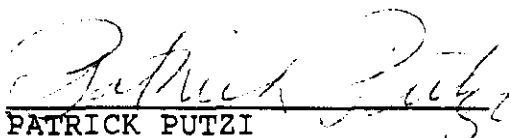
When we briefed the Chief Counsel on the issues presented in this case, he agreed that the issues should be vigorously defended. Accordingly, we are treating these issues as a major controversy within the [REDACTED] and [REDACTED] industry

and we are coordinating them through the Industry Specialization Program.

To keep our internal records current, we are temporarily closing this case on the CATS system, but we will reopen it at a later date to issue our memorandum setting forth our further research. Please contact Gerald Fleming at FTS 566-3345 or Patrick Putzi at FTS 566-3308 if you have any questions.

MARLENE GROSS
Director

By:


PATRICK PUTZI
Special Litigation Counsel
(Natural Resources)
Tax Litigation Division

Attachment:
As stated.

cc: Mr. Jankowitz